



Monetary Policy in Emerging Markets: Key Current IT Themes

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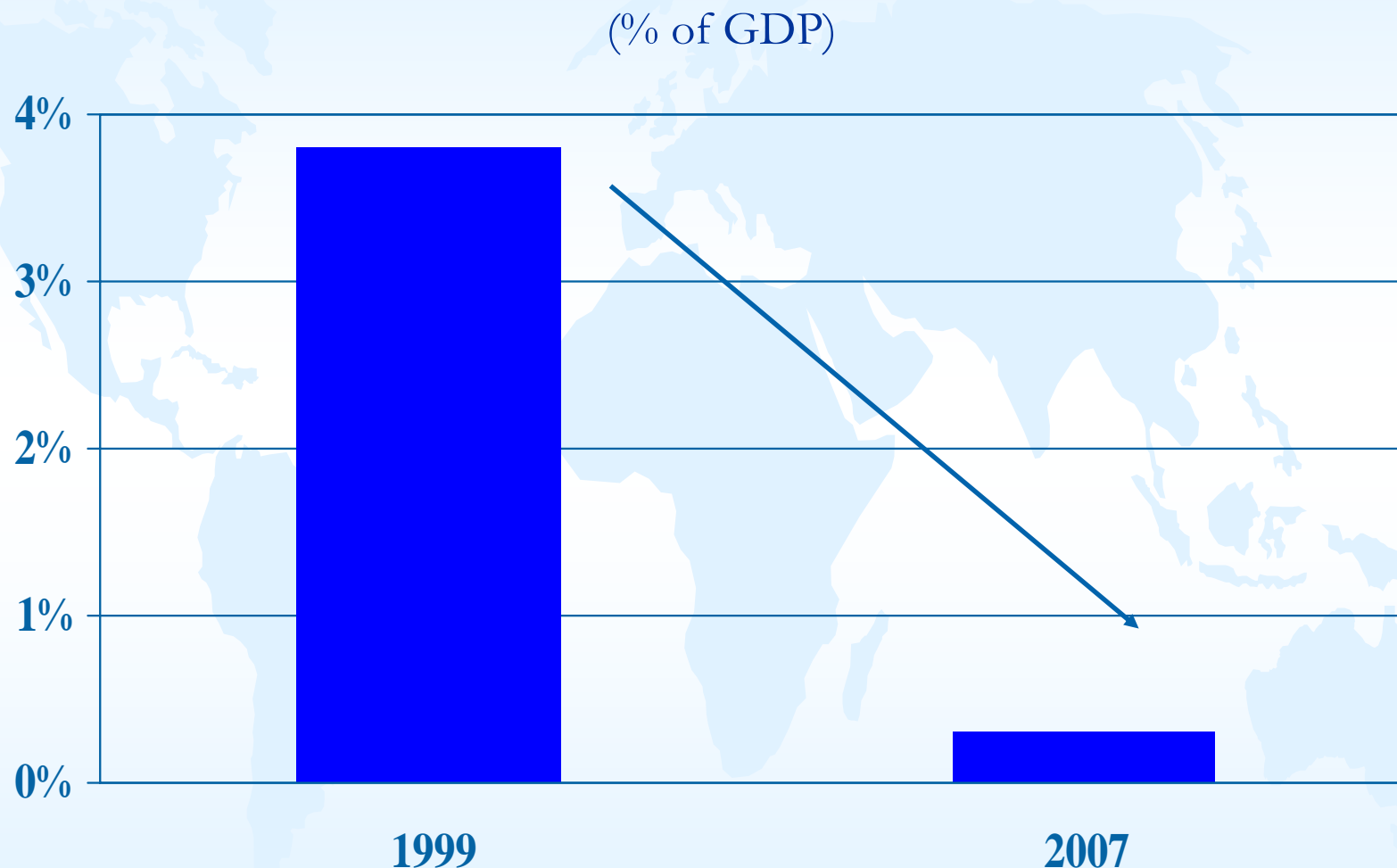
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Current Global Conditions Provide Strong Support for IT in Emerging Markets

- Globalization has resulted in lower inflation rates
- World interest rates have remained low
- Rapid growth and reforms have improved EM's fiscal stance
- EM external accounts have improved
- Capital mobility has contributed to monetary/fiscal policy discipline
- A diminishing role of political uncertainties for market movements?

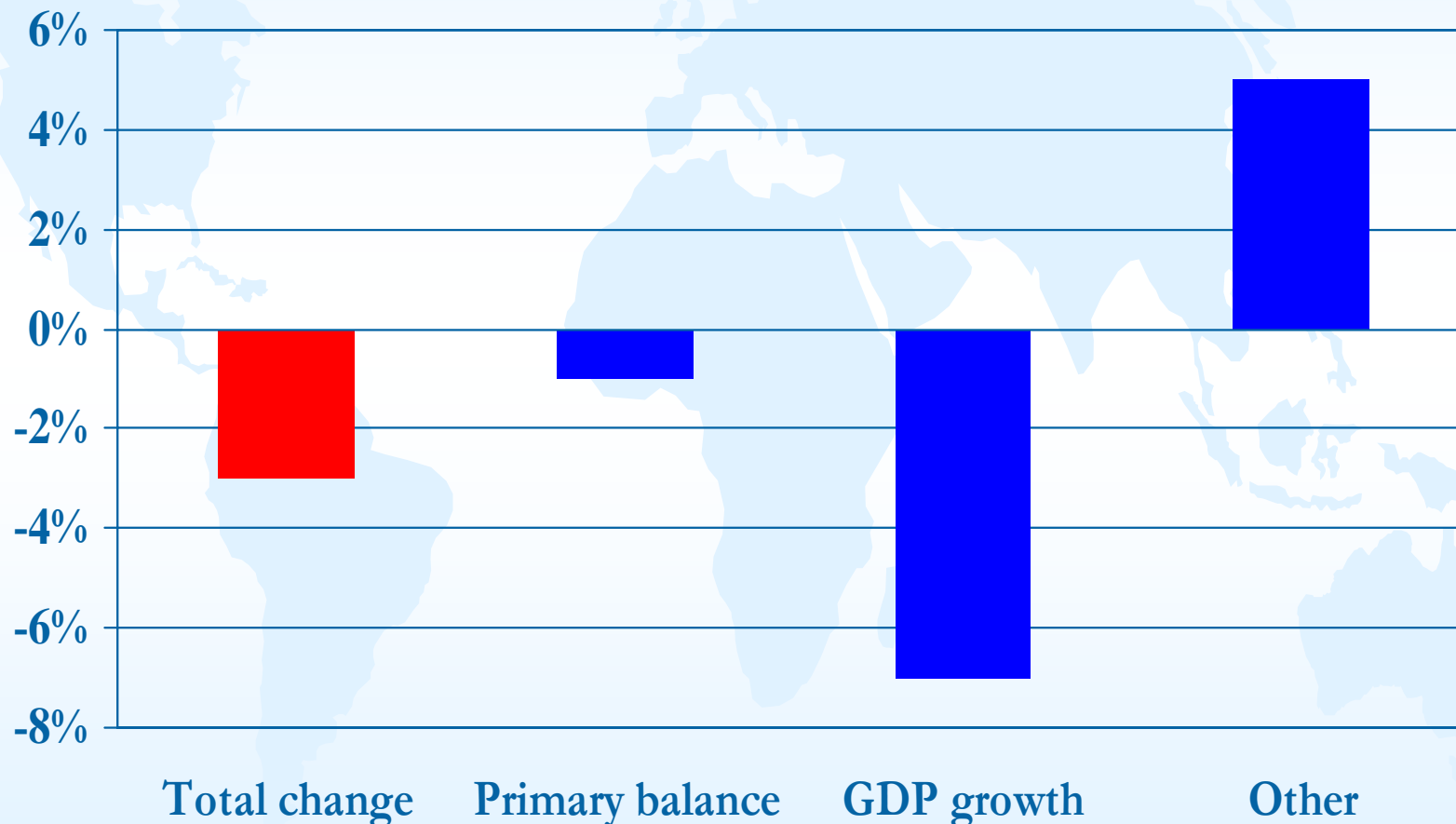
A Marked Decline in EM Budget Deficits



Source: WEO 9/2006, IMF. The figures correspond to the central government budget deficit of “other emerging market and developing countries.” The figure for 2007 is an IMF forecast..

Rapid GDP Growth Helped Reduce Public Debt to GDP Ratios

(% of GDP change from end 2001 to end 2005)



Source: WEO 9/2006, IMF. "Other" includes: exchange rate and interest rate effects, the stock-flow adjustment and statistical discrepancy

Changes in Global Risk Aversion Have Been Key for EEM Volatility in 2006

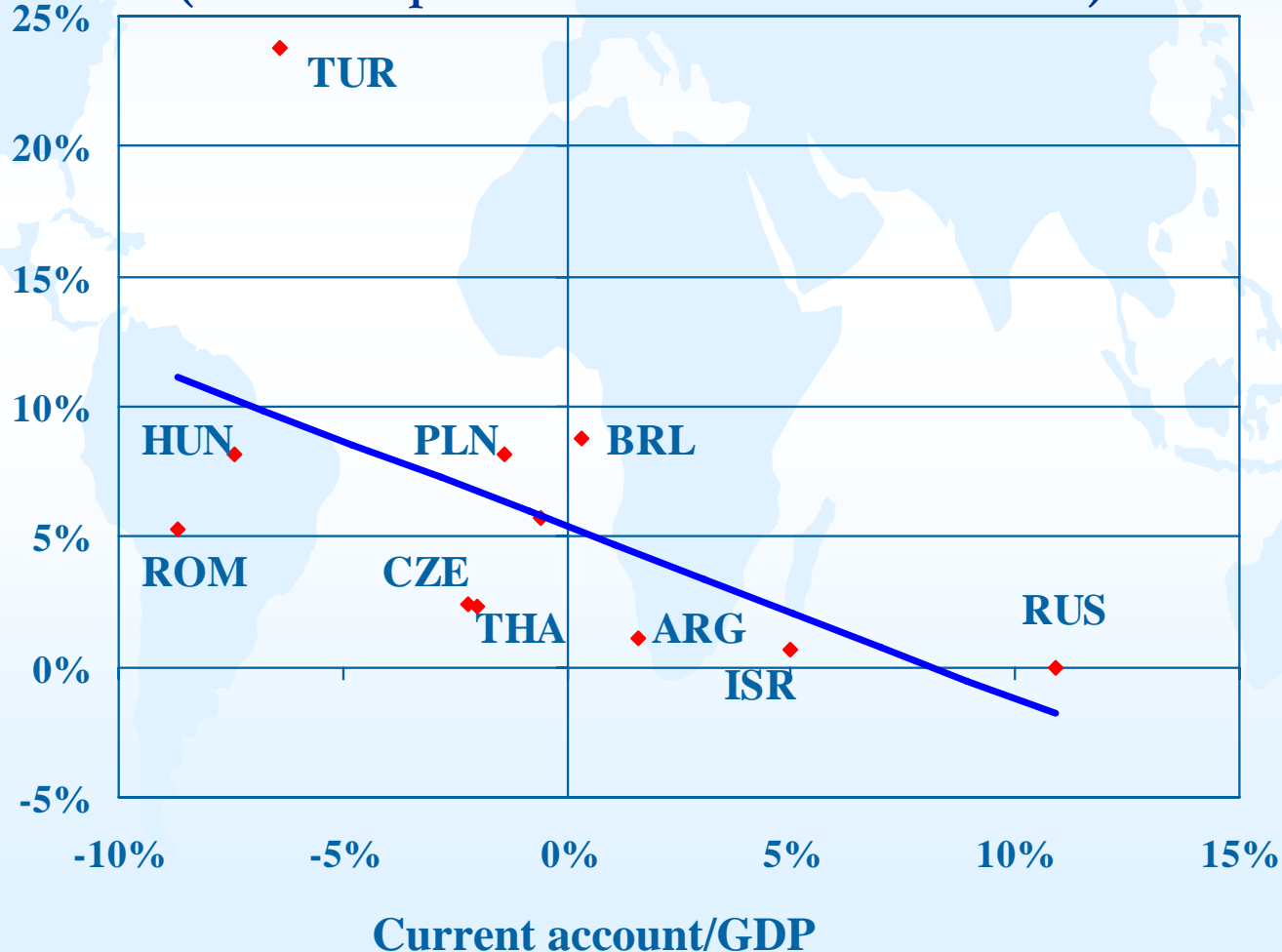


Note: index for the EEM ETF (end of 2005=100).

The Current Account/Monetary Policy Link: Larger Currency Depreciation Under Weaker External Accounts

(Mid '06 Episode of Global Risk Aversion)

Currency depreciation 10.5.06-22.6.06



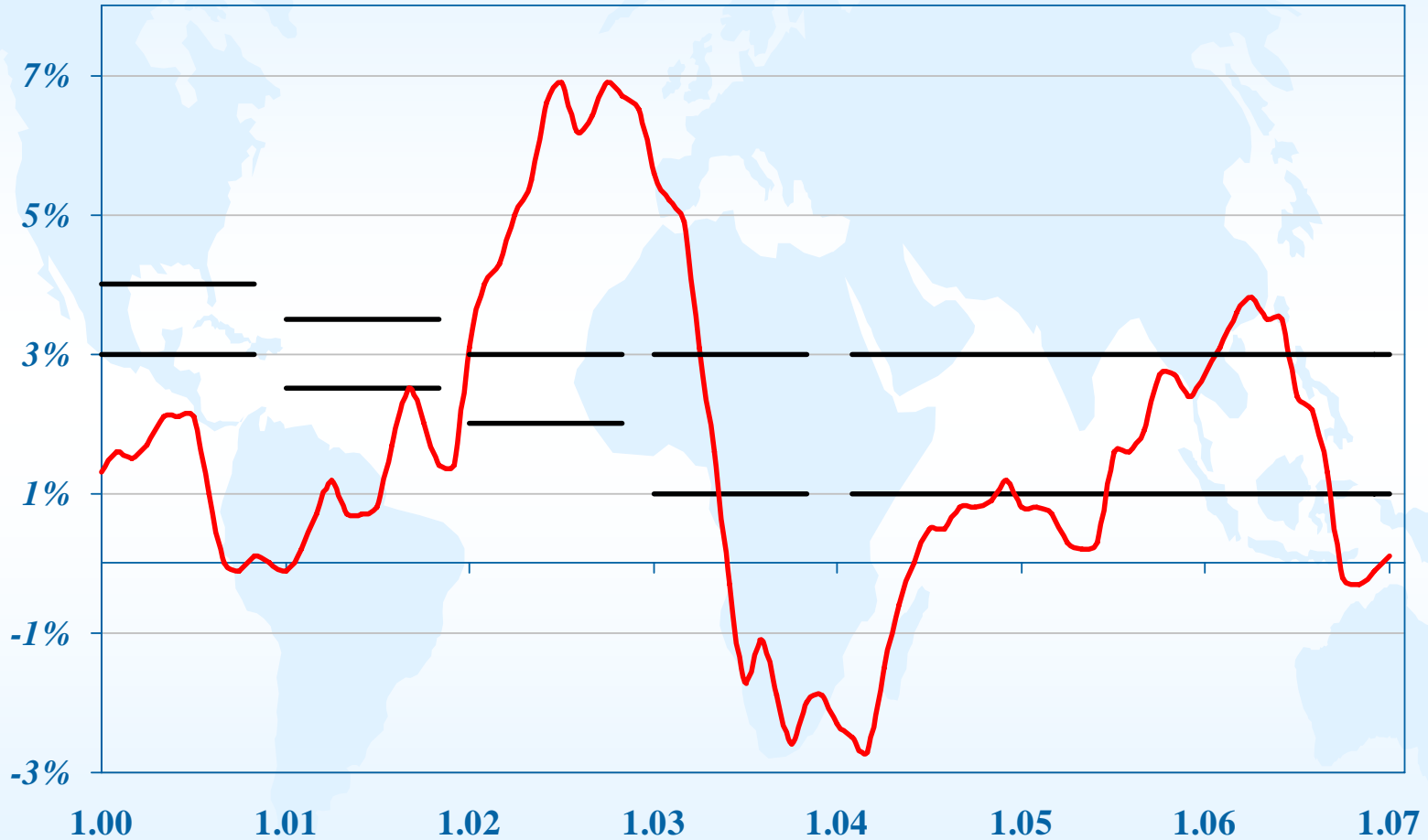
The Main Risk Ahead

Slower economic growth and weaker fundamentals could make monetary policy in emerging-market economies more vulnerable to adverse shocks.



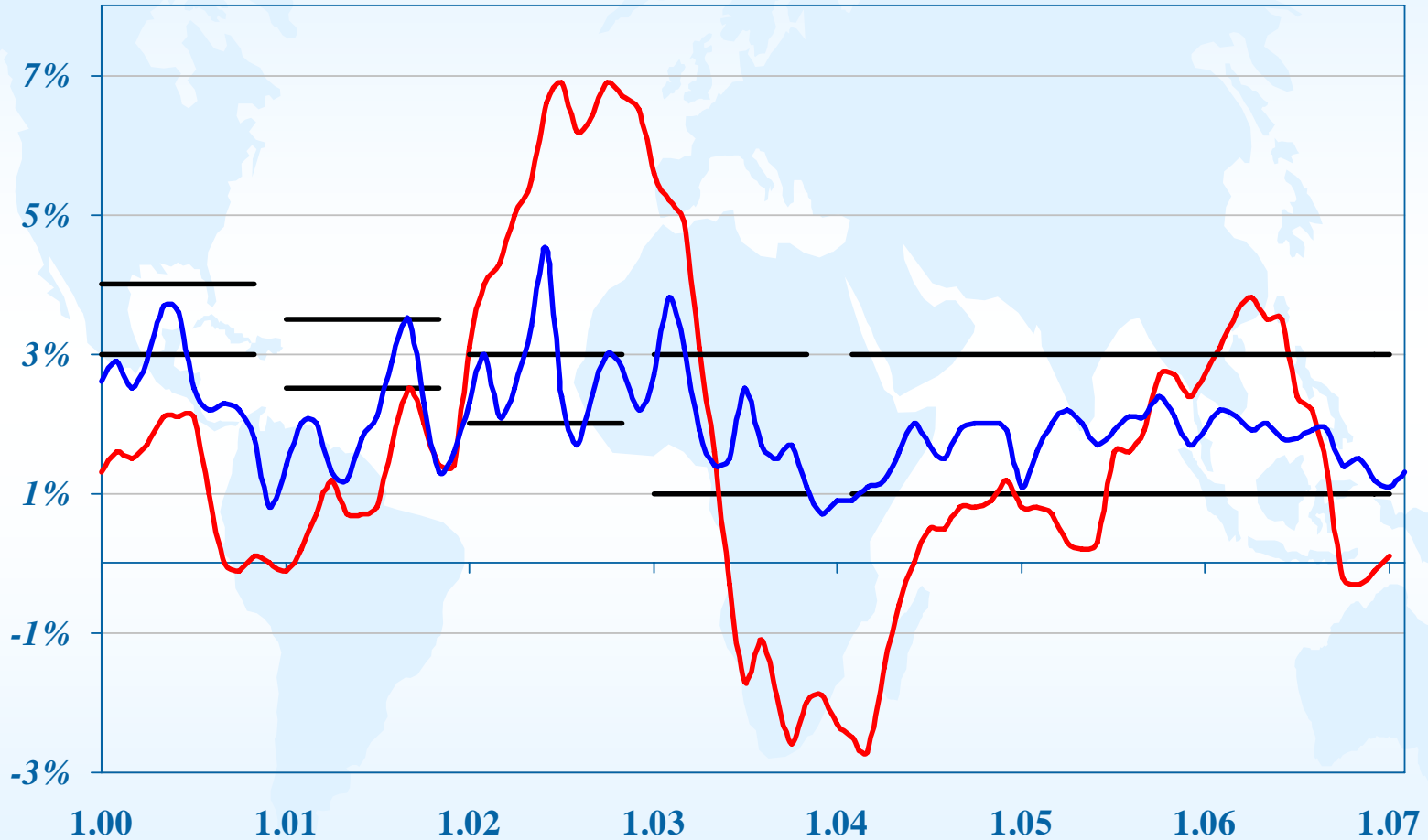
**An Illustration of Current IT Themes
Based on Israel's Experience**

Inflation Volatility has Resulted in Deviations from IT...



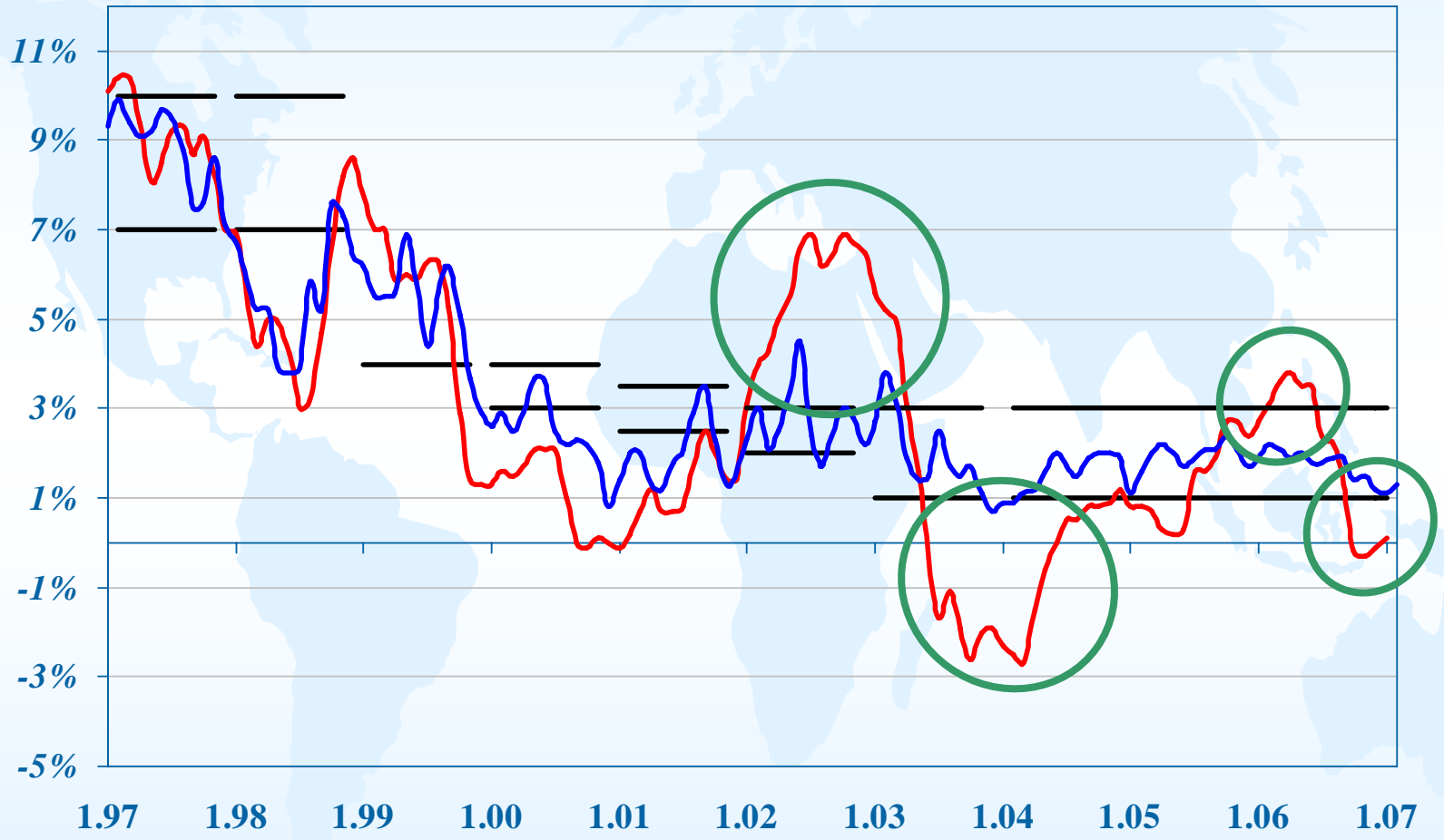
— CPI YoY — Official inflation targets

...Yet Inflation Expectations Have Remained Within Targets



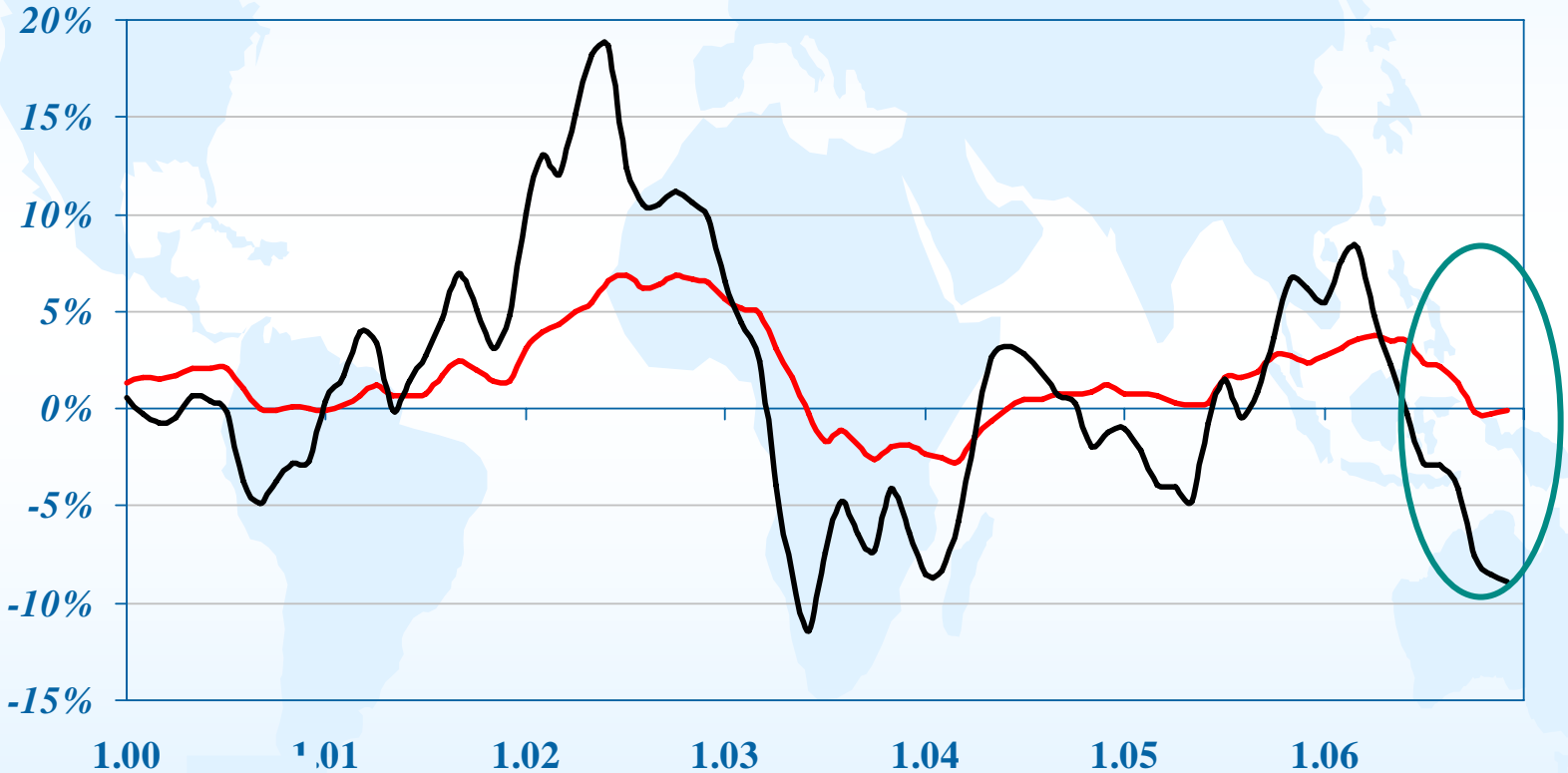
- CPI YoY
- Official inflation targets
- 12-month break-even inflation

Inflation Expectations Appear Now Less Adaptive than in the Past



- CPI YoY
- Official inflation targets
- 12-month break-even inflation

Although the Pass-through has Diminished, The Nominal Exchange Rate Still has a Dominant Role in the Transmission Mechanism



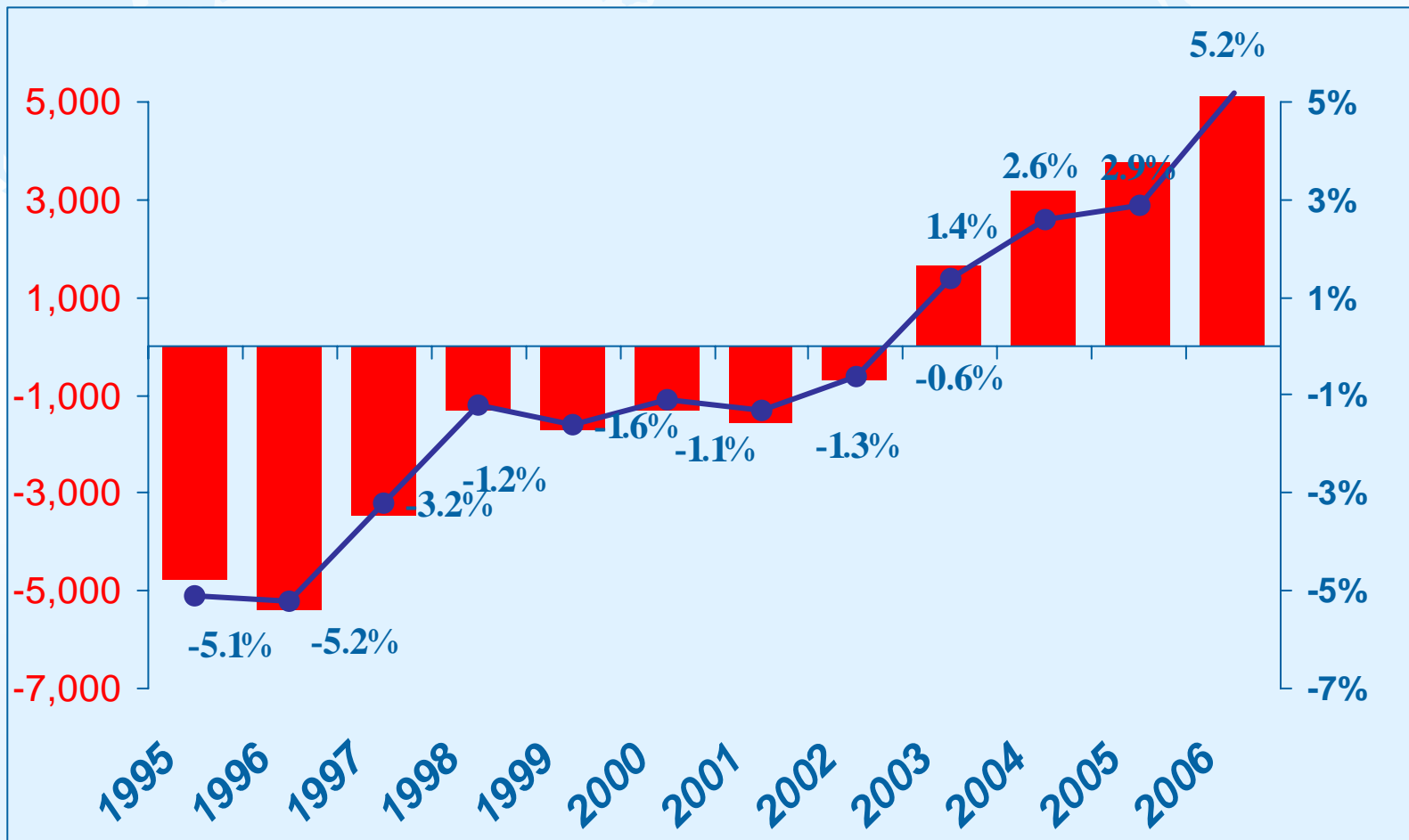
— CPI YoY — \$/NIS - YoY

ILS Recent Strength Resulted from Improved Current Account Performance...

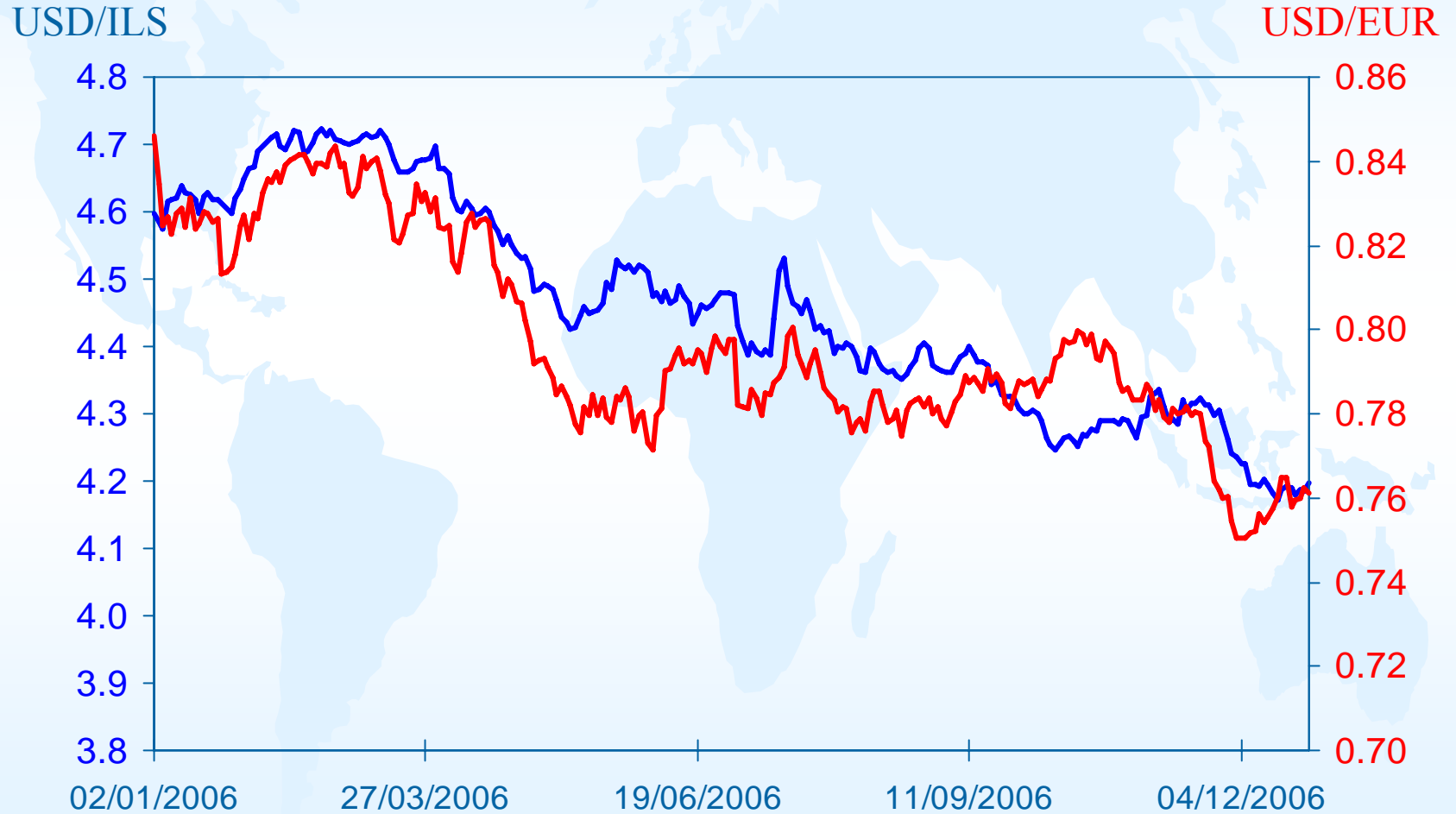
(Israel's current account surplus)

\$ millions

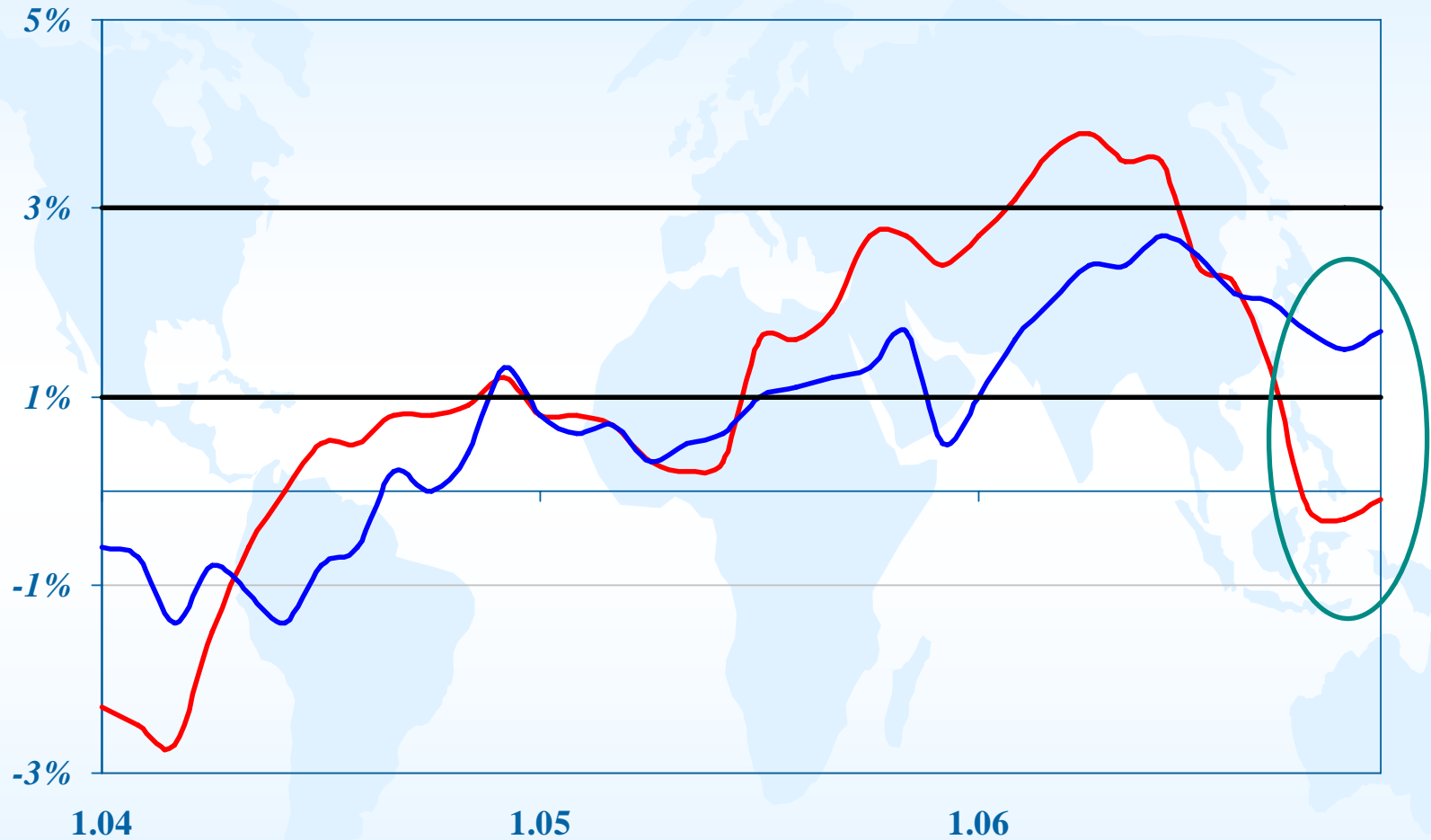
% of GDP



...as well as from USD weakness

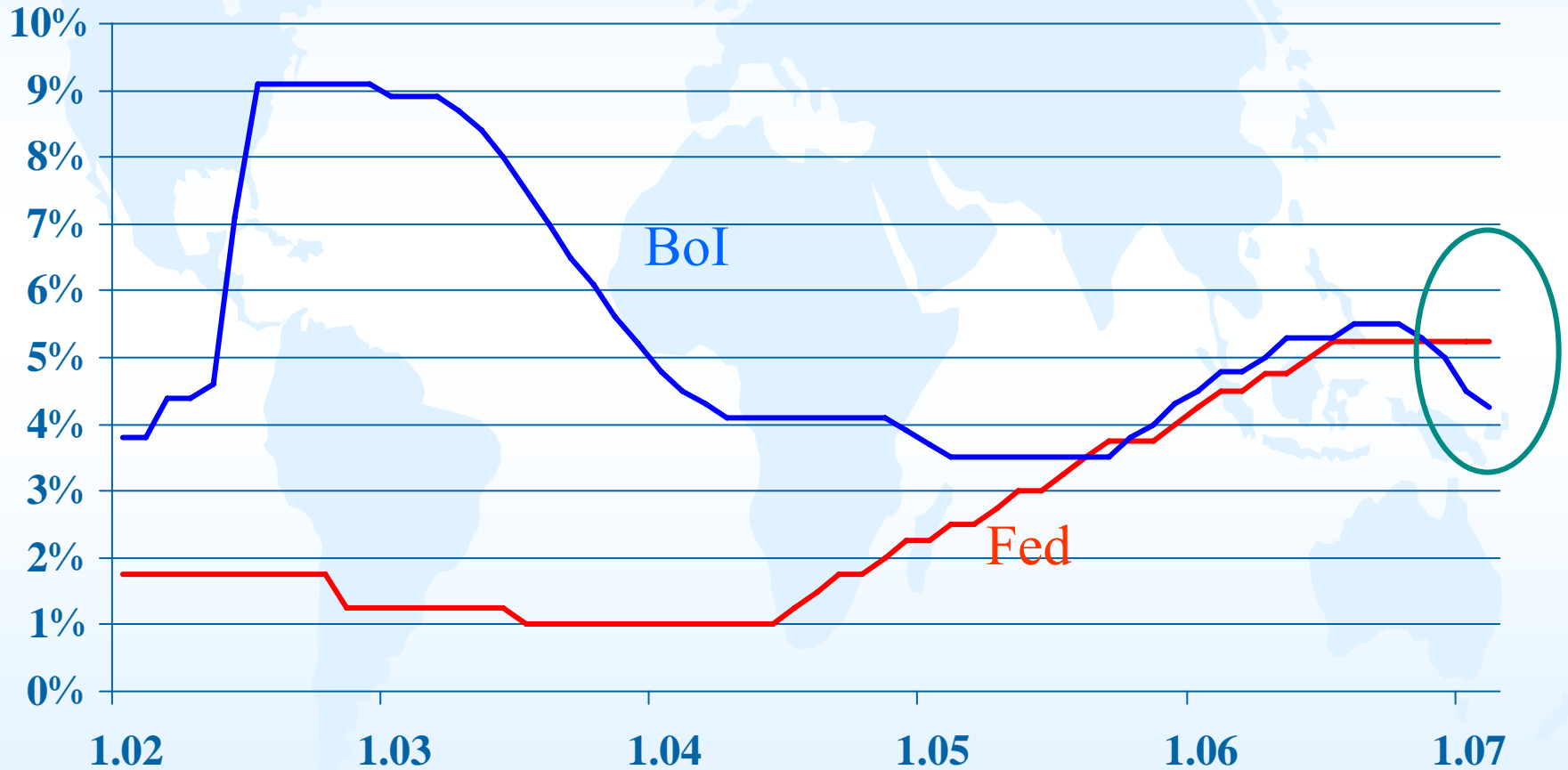


Should the IT Rely on Core Inflation?



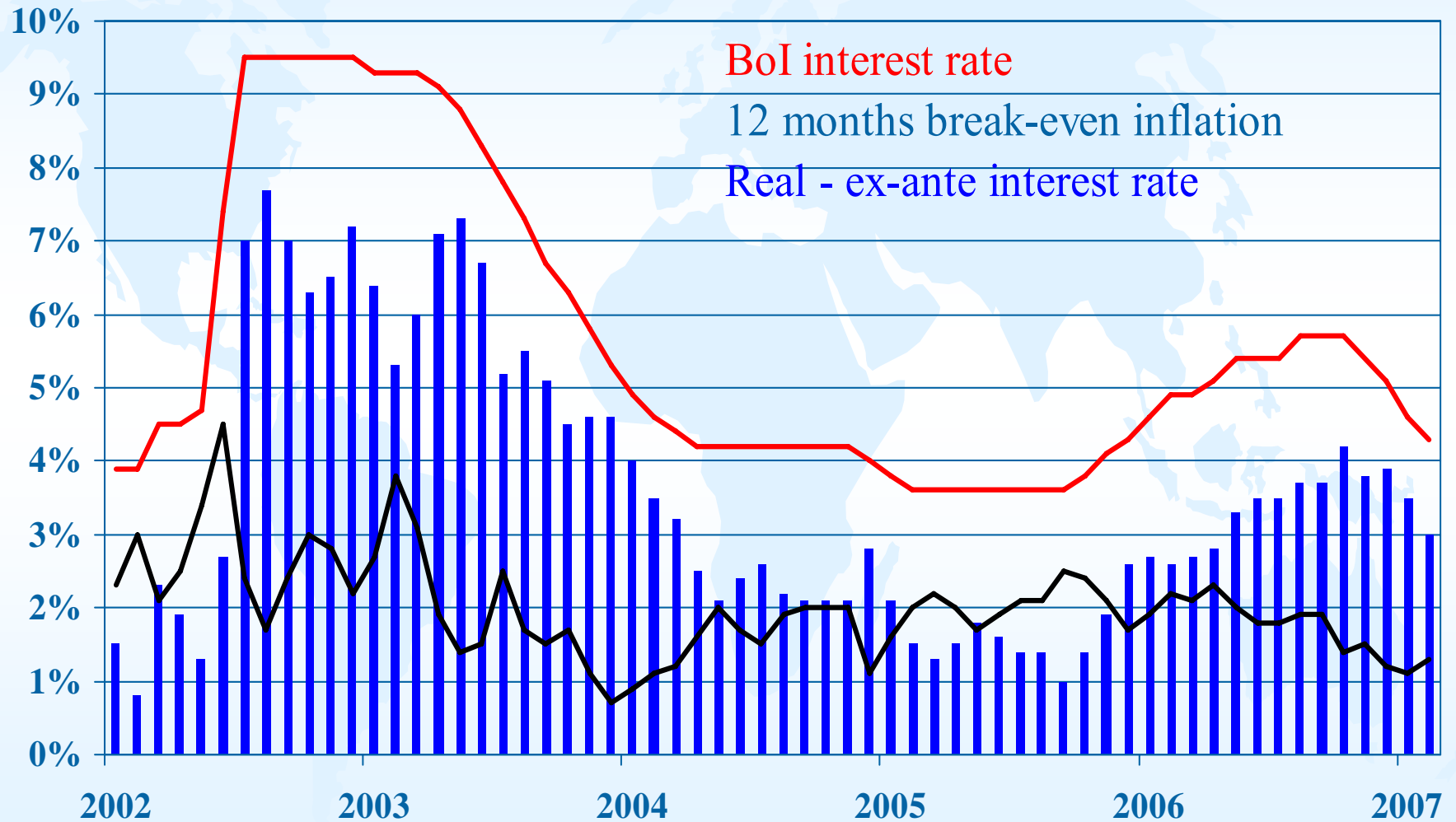
- CPI
- Core inflation (excl. housing and energy)

Entering New Territory for Monetary Policy: The BoI Rate is Lower than the FedFunds Rate...



Bank of Israel and Federal Reserve policy rates.

...Yet Ex-Ante Real Interest Rates Remain Reasonable



Source: Bank of Israel.



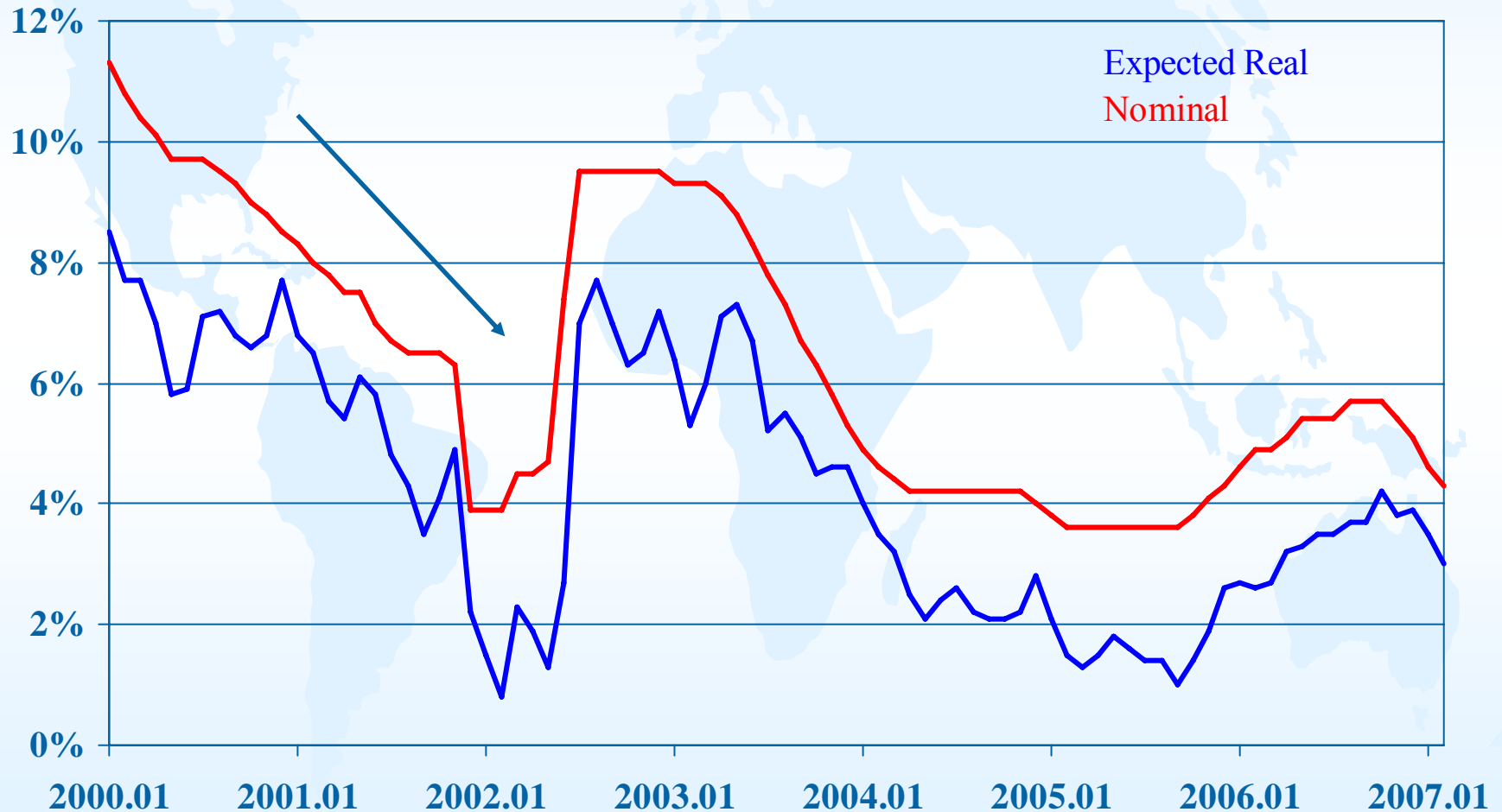
Looking Back at the 2002 Monetary/Fiscal Policy Mistake

Inflation target: 2-3%

Actual inflation: 6.5%

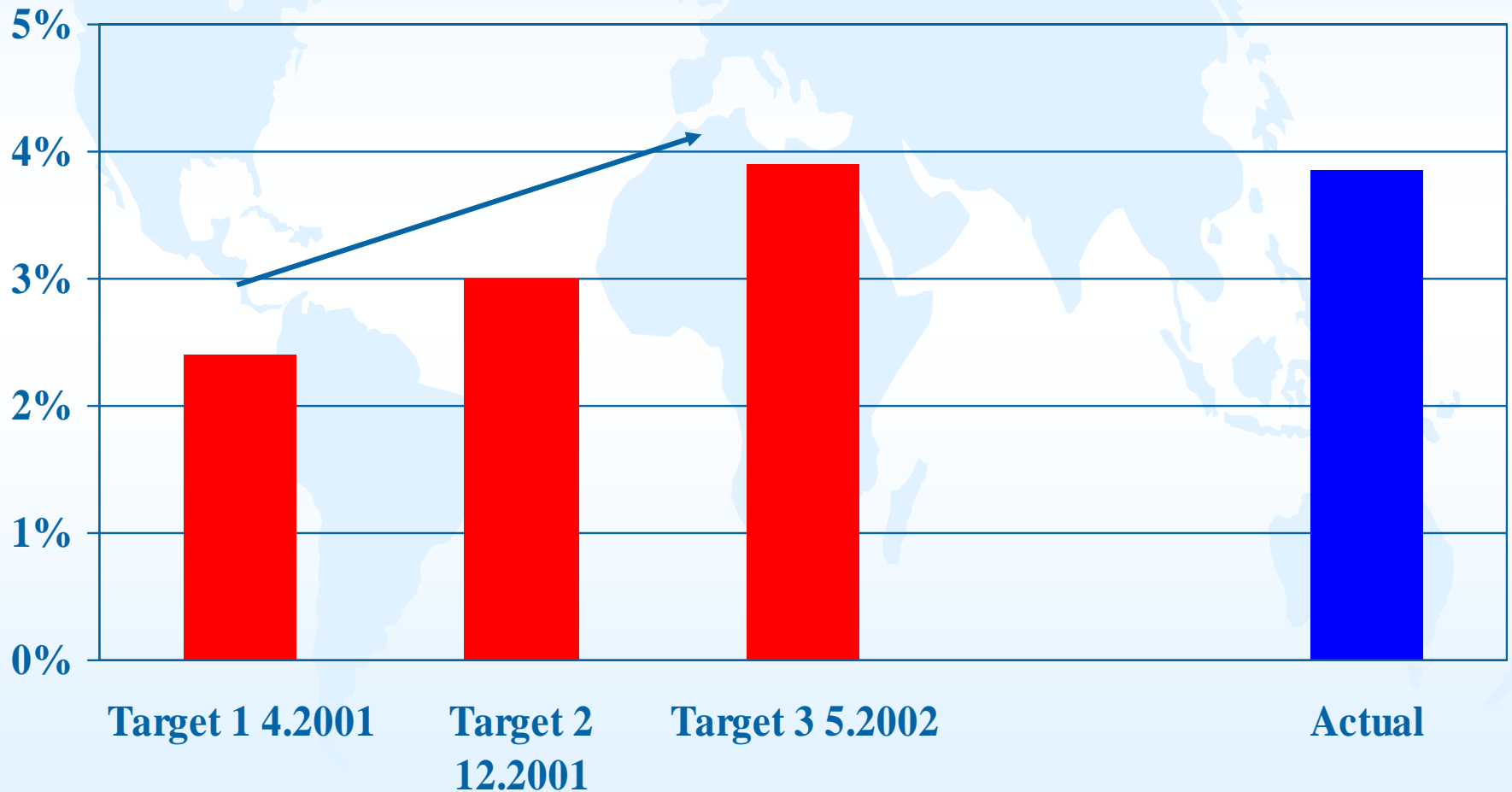
Policy Rate: A Surprise Move to Easy Money in 12.2001

(central bank interest rates)



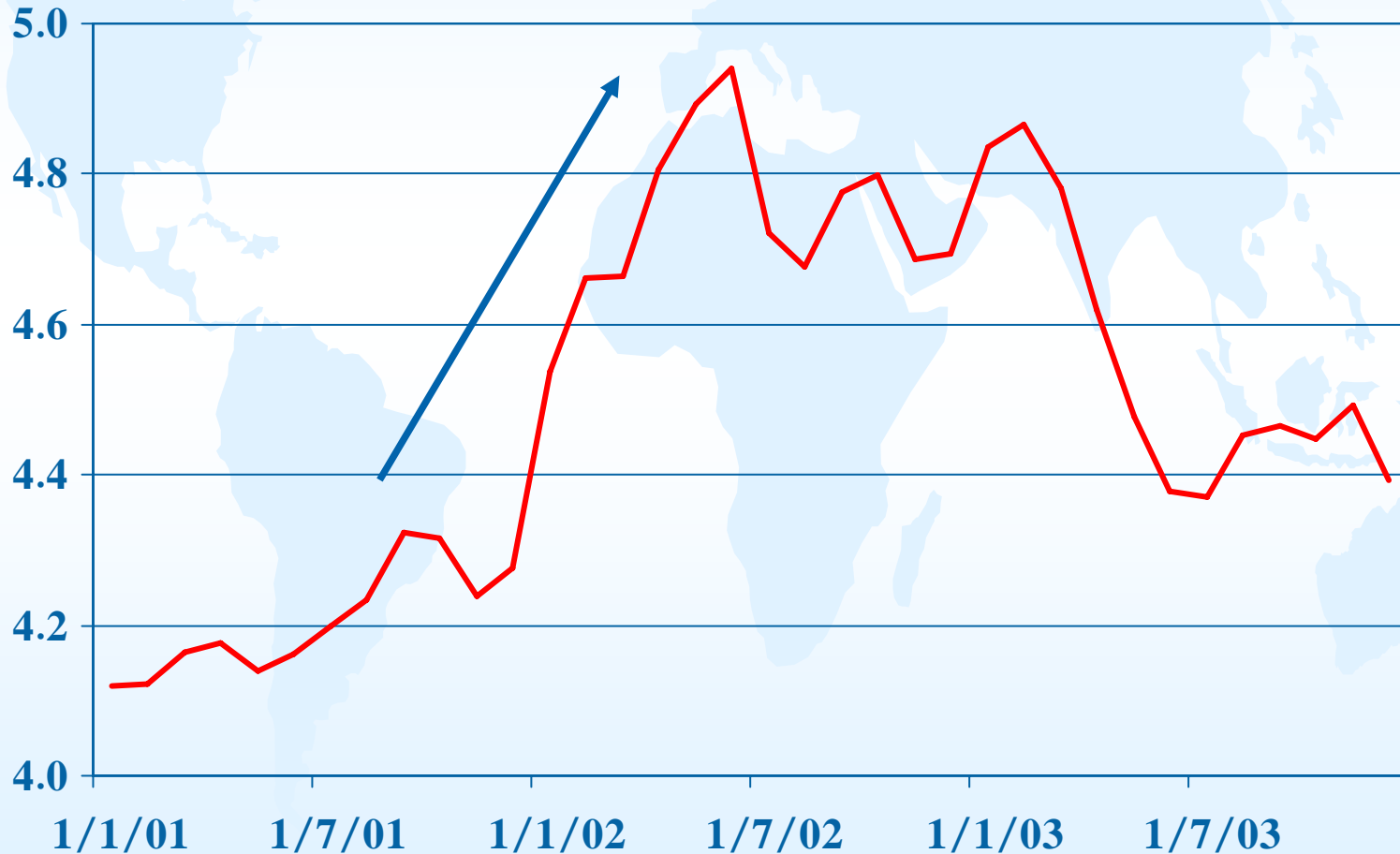
The Budget Deficit in 2002: Revising the Target Frequently

(Ratios of Budget Deficit to GDP)



Fiscal and Monetary Expansion Resulted in Rapid ILS Depreciation Against the USD

USD/ILS



Concluding Remarks

- The need for flexibility in implementing IT in emerging-market economies...
- ...yet credibility is especially needed in a 'flexible' IT regime
- The need for defining the IT horizon “over the medium term”
- Less benign global conditions and weaker fundamentals could pose more difficult tradeoffs for EM monetary policies ahead